Potential project essay

Analyzing the data of sales forecasts and predetermined direct costs including fixed manufacturing overhead provides a positive possible benefit generated y the potential project. However, the given data is not sufficient enough to provide correct estimates for the project. It does not consider such factors as time value of money, as well as investment of initial net investment, and also the exact portion of cash sales. In order to make more precise forecasts as for the project's profitability capital budgeting analysis should be performed. In order to achieve a more precise determination of the affects caused by purchasing an asset the Net Present Value technique should be used, which involves discounting net cash flows for a project, then subtracting net investment from the discounted net cash flows. The result, NPV, show the affects of purchasing an asset (considering real, not financial).

If the net present value is positive, adopting the project would add to the value of the company. First we calculate Net Investment, which consists of cost of a new product plus installation costs, and less precedes from disposal of old assets. The net investment of a new machine equals the purchase price in this case as it does not replace any of the old assets – ? 1, 000, 000. Consequently, net cash flow discounting generates a positive result, which suggests that this particular project will benefit the organization by providing an additional benefit to the firm's cash inflows. NPV of the project is ? 135, 272. Furthermore, calculations suggest that break-even point will be reached somewhere between year three and four.

Depreciation expense is not relevant to the decision of purchasing a new asset. The next further concern of acquiring a new asset will be the assets increased y sales of the product. As NPV analysis based on discounting potential cash inflow, failure to receive the projected amount of cash might result in significant losses and inability to generate enough profits to cover all costs of the asset before it fully depreciates. Therefore, a critical matter in this case is to determine what portion of sales revenue will be received on account and what portion is cash sale. In case of significant credit sales, some more assumptions concerning estimated uncollectible accounts should be made.

It is critical to generate as much cash sales as possible in order maintain the positive NPV of the project. As for the leasing the option, in order to achieve the same benefits as for the potential profit, the company can lease an asset paying 200, 000 annually. Another important matter, which will determine the actual success of the profit, is the amount fixed indirect costs incurred in the operations. In case of significant fixed costs the company should put all the effort into increasing sales to its maximum.

In case of insignificant fixed costs the company may choose the option that is more practically efficient – whether to concentrate on increasing of the quantity sold or experiment with price that will yield maximum profit. In this case, maximum sales may not mean maximum profit. The option of lowering the price for the last two years aiming to increase sales will primarily depend on the elasticity of demand for the product. If elasticity of demand is high, or say higher than 1, the decrease in sale price will yield higher sales, and consequently greater profits.